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Nos. 03-892 and 03-907

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIGITAS J. BANAITIS

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURTS OF APPEALS
FOR THE SIXTH AND NINTH CIRCUITS

REPLY BRIEF FOR THE PETITIONER

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TABLE OF CONTENTS

	Page
A. Federal tax law makes clear that respondents earned all of the income recovered on their causes of action	1
1. Respondents' attorneys were not co-owners, partners, or joint venturers in respondents' causes of action	2
2. The attorneys were not the "true earners" of the litigation proceeds	6
3. Respondents had sufficient control over the contingent-fee portion of the proceeds to warrant its inclusion in their gross income	9
4. The assignment-of-income doctrine is not limited to so-called "anti-abuse" situations or assignment of already-ascertained income	11
5. There is no proscription in the tax law against the purported of "double taxation" at issue here	14
B. The contingent-fee portion of the proceeds is includable in respondents' gross income because it satisfied respondents' debts to their attorneys	15
C. Any inequity that may result from the application of the AMT to contingent attorney's fees is within the sole power of congress to remedy	17

TABLE OF AUTHORITIES

Cases:

Alexander v. *IRS*, 72 F.3d 938 (1st Cir. 1995)	17-18
Adams v. *Transamerica Ins. Group*, 609 P.2d 834 (Or. Ct. App. 1980)	5
Baylin v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995)	2, 16

Cases—Continued: Page

Benci-Woodward v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001) 4
Blanchard v. *Bergeron*, 489 U.S. 87 (1989) 19
Carpa, Inc. v. *Ward Foods, Inc.*, 536 F.2d 39 (5th Cir. 1976) 19
Chauffeurs, Teamsters & Helpers Local No. 391 v. *Terry*, 494 U.S. 558 (1990) 10
Commissioner v. *Asphalt Prods. Co.*, 482 U.S. 117 (1987) 17
Commissioner v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990) 9
Commissioner v. *Sunnen*, 333 U.S. 591 (1948) 10
Corliss v. *Bowers*, 281 U.S. 376 (1930) 9
Evans v. *Jeff D.*, 475 U.S. 717 (1986) 19
Ferri v. *Ackerman*, 444 U.S. 193 (1979) 3
Goodman v. *Heublein, Inc.*, 682 F.2d 44 (2d Cir. 1982) 19
Helvering v. *Horst*, 311 U.S. 112 (1940) 1, 2, 10, 11
Hensley v. *Eckerhart*, 461 U.S. 424 (1983) 18
Hukkanen-Campbell v. *Commissioner*, 274 F.3d 1312 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002) 2, 16
Isrin v. *Superior Court*, 403 P.2d 728 (Cal. 1965) 4
Kenseth v. *Commissioner*, 259 F.3d 881 (7th Cir. 2001) 7, 8-9, 11, 16
Lucas v. *Earl*, 281 U.S. 111 (1930) 1, 12
NAACP v. *Button*, 371 U.S. 415 (1963) 3
Old Colony Trust Co. v. *Commissioner*, 279 U.S. 716 (1929) 1, 12, 15, 16
Potter v. *Schlesser Co.*, 63 P.3d 1172 (Or. 2003) 6
Raymond v. *United States*, 355 F.3d 107 (2d Cir. 2004), petition for cert. pending, No. 03-1415 (filed Apr. 9, 2004) 2, 11, 12, 13
Sinyard v. *Commissioner*, 268 F.3d 756 (9th Cir. 2001), cert. denied, 536 U.S. 904 (2002) 19

Cases—Continued:

	Page
Smith v. *United States Nat'l Bank*, 615 P.2d 1119 (Or. Ct. App. 1980)	5
Young v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001)	2

Statutes and rules:

26 U.S.C. 56(b)(1)(A)	17
26 U.S.C. 56(b)(1)(A)(i)	14, 15
26 U.S.C. 61	11, 12
26 U.S.C. 62 (2000 & Supp. I 2001)	18
26 U.S.C. 67(b)	14, 17
26 U.S.C. 211	17
26 U.S.C. 212(1)	14, 17
26 U.S.C. 6110(k)(3)	13
Or. Rev. Stat. § 87.445 (2003)	5, 6
Or. Code of Prof'l Responsibility DR 3-103 (2004)	4, 5
Cal. R. Prof'l Conduct 1-310 (2004)	4
Model Rules of Prof'l Conduct Rule 5.4(b)	4

Miscellaneous:

Bill Summary and Status for the 108th Congress <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:HR04520:@@@X>	18
Black's Law Dictionary (7th ed. 1999)	5-6, 16
Jumpstart Our Business Strength (JOBS) Act, H.R. 4520, 108th Cong., 2d Sess. (2004)	18
1 William S. McKee et al., *Federal Taxation of Partnerships and Partners* (3d ed. 1997)	3
P.L.R. 200427009 (Mar. 19, 2004)	13
Restatement (Third) of the Law Governing Lawyers (2000)	3
Rev. Rul. 80-364, 1980-2 C.B. 294	14

REPLY BRIEF FOR THE PETITIONER

Petitioner's opening brief demonstrated (Br. 14-25) that federal tax law requires respondents to include in their gross income the entire amount of their litigation proceeds, including the portion paid as fees to their attorneys. It is a fundamental rule of federal tax law that income is taxed to the person who earns it, even when it is paid at that person's direction to someone else. *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930). It is similarly well settled that, when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives "income" in the amount of the discharged debt. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929). Thus, as the Court explained in *Helvering* v. *Horst*, 311 U.S. 112, 116-117 (1940), "he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." Accordingly, where a taxpayer assigns to another "an obligation to pay compensation" to the taxpayer, he has "divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants" and is subject to tax on the diverted proceeds. *Id.* at 117, 118. Those federal tax law principles require the inclusion of the full amount of litigation proceeds in respondents' gross income.

A. Federal Tax Law Makes Clear That Respondents Earned All Of The Income Recovered On Their Causes Of Action

Respondents, and respondents alone, suffered the injuries that gave rise to their causes of action; they were the sole owners of their causes of action; and they had the sole right to assert and settle their claims. Their injuries gave rise to claims for recoveries in the form of taxable income, and the settlement proceeds represent the value given as compensa-

tion for those injuries and in exchange for the dismissal of their claims. Respondents therefore owned, controlled, and were "the source of the income" at issue. *Horst*, 311 U.S. at 116.

This would all be undisputed if the attorneys had charged an hourly fee, and nothing in the Internal Revenue Code authorizes radically more favorable tax treatment for those who opt for contingent-fee arrangements. Through their contingent-fee agreements, respondents "divert[ed] the payment [of a portion of that income] from [themselves] to others as the means of procuring the satisfaction of [their] wants," namely legal services. *Horst*, 311 U.S. at 117. Accordingly, the proceeds from respondents' litigation awards are "recover[ies] of lost income; the attorney fees [they] paid represent expenses incurred in generating that income"; and "[l]ike any other taxpayer, [respondents] must report the entire amount as gross income." *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312, 1314 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002); accord *Raymond* v. *United States*, 355 F.3d 107 (2d Cir. 2004), petition for cert. pending, No. 03-1415 (filed Apr. 9, 2004); *Young* v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995).

Respondents and their amici raise a number of arguments in an attempt to evade these controlling principles of federal tax law. All of those arguments are unavailing for the reasons described below and in petitioner's opening brief (Br. 26-35).

1. Respondents' attorneys were not co-owners, partners, or joint venturers in respondents' causes of action

A central theme running through the briefs of respondents and their amici is that the relationship between client and attorney under a standard contingent-fee agreement is that of partners or joint venturers wherein the client contributes the capital (in the form of his cause of action) and the attorney contributes his professional services. According to

this theory, the amounts recovered on respondents' causes of action represented the proceeds from that partnership and are jointly owned by respondents and their attorneys. But the basic premise of that argument is patently erroneous.[1]

"A profit-oriented business arrangement is not a partnership unless two or more of the participants have an interest in the partnership *as proprietors*." 1 William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 3.02[5], at 3-15 (3d ed. 1997) (emphasis added) (citations omitted). The relationship of attorney and client, however, is one of agent and principal, not co-proprietorship. As stated in the Restatement (Third) of the Law Governing Lawyers, ch. 2 introductory note (2000), the client-lawyer relationship is "a voluntary arrangement in which an agent, a lawyer, agrees to work for the benefit of a principal, a client. A lawyer is an agent." See *Ferri* v. *Ackerman*, 444 U.S. 193, 204 (1979) (an attorney's "principal responsibility is to serve the undivided interests of his client"); *NAACP* v. *Button*, 371 U.S. 415, 460-461 (1963) ("[t]he relation of attorney and client is that of master and servant in a limited and dignified sense") (citation omitted). Moreover, while lawyers, as agents, owe a fiduciary duty to act in the best interests of their clients, clients owe no such reciprocal duty to their lawyers. See Restatement (Third) of the Law Governing Lawyers, ch. 2, § 17 & cmt. a (describing clients' duties to lawyer as "less extensive" and principally contractual and related to the payment of fees).

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[1] Respondent Banaitis goes so far as to argue—for the first time—that "[t]his case is governed by Subchapter K of the Internal Revenue Code," (Br. 1), which governs taxation of partnership profits. Banaitis never raised that argument below or in his brief in opposition, and it is therefore waived. Indeed, neither Banaitis in his lower court briefs nor the Ninth Circuit in its opinion ever cited to a single provision of Subchapter K. His sole argument, adopted by the court of appeals, was that Oregon's attorney lien statute "vests attorneys with property interests" that justify treating the contingent-fee portion of litigation proceeds as belonging to the attorney for tax purposes. Banaitis Pet. App. 16a; see Banaitis Br. in Opp. 7 ("[T]his is essentially a state law case.").

These authorities confirm that the relationship of attorney and client, under a contingent-fee agreement or otherwise, is one of principal and agent. It is not and cannot be a joint business undertaking. Indeed, Rule 5.4(b) of the Model Rules of Professional Conduct provides that "[a] lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law." Both California and Oregon have adopted this Rule. See Cal. R. Prof'l Conduct 1-310 (2004); Or. Code of Prof'l Responsibility DR 3-103 (2004).

Respondents ignore these authorities in baldly proclaiming that a contingent-fee agreement renders a client and his attorney partners or joint venturers. They cannot even point to any language in their respective contingent-fee agreements that purports to establish such a relationship. See J.A. 94-97, 99-105. Nor is there anything in the provisions of the applicable state law that supports respondents' anomalous position that their relationship with their attorneys was that of partners or joint venturers.

Respondent Banks's contingent-fee agreement is governed by California law. In *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (2000), cert. denied, 531 U.S. 1112 (2001), the Ninth Circuit examined the respective rights of attorneys and their clients under a contingent-fee agreement and held that California law "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." *Id.* at 943. Indeed, the Supreme Court of California has made clear that, "in whatever terms one characterizes an attorney's lien under a contingent fee contract, it is no more than a *security* interest in the *proceeds* of the litigation," and "do[es] not operate to transfer a part of the cause of action to the attorney." *Isrin* v. *Superior Court*, 403 P.2d 728, 732 (1965) (citation omitted). It is thus apparent that respondent Banks and his attorney were not partners or joint venturers, but rather that their relationship at the time the attorney's

fees were paid was that of principal-agent and debtor-creditor.

Similarly, Oregon law, which governs respondent Banaitis's contingent-fee agreement, does not confer on the attorney any ownership interest in his client's cause of action or otherwise give the attorney control over the action. Rather, like most States, Oregon grants an attorney a lien on the litigation and its proceeds to secure payment of his fees. Or. Rev. Stat. § 87.445 (2003). Banaitis's assertion (Br. 33-36) that Oregon's attorney lien statute somehow precludes a party from settling or otherwise resolving his case without his attorney's consent is mistaken. See *Adams* v. *Transamerica Ins. Group*, 609 P.2d 834, 837 (Or. Ct. App. 1980) ("[A]n attorney has no interest in a settlement agreement independent of that of his client. If the attorney is entitled to attorney's fees he may maintain an action against his client for those fees. However, he does not have standing to maintain this suit" challenging the settlement.) (footnote omitted); *Smith* v. *United States Nat'l Bank*, 615 P.2d 1119, 1123 (Or. Ct. App. 1980) ("Even where an attorney has an interest in litigation, such as a contingent fee contract, * * * the client is under no duty to appeal an adverse trial court judgment.").

As with California's and most other States' attorney lien statutes, moreover, Oregon's statute draws no distinction between fees due under an hourly-fee arrangement and those due under a contingent-fee agreement; both types of attorneys receive the same lien. Accordingly, Oregon's attorney lien statute can provide no basis for treating contingent-fee lawyers, but not hourly-rate lawyers, as partners or co-owners in their clients' causes of action, a result that would also run afoul of Oregon's code of ethics. Or. Code of Prof'l Responsibility DR 3-103. Moreover, the concepts of lienholder and property owner are mutually exclusive, since a property owner cannot have a lien on his own property. See *Black's Law Dictionary* 933 (7th ed. 1999) (defining

"lien" as "[a] legal right or interest that a creditor has *in another's property*") (emphasis added).

Banaitis's reliance (Br. 33) on the decision in *Potter* v. *Schlesser Co.*, 63 P.3d 1172 (Or. 2003), is misplaced, because *Potter* does not purport to hold that a contingent-fee attorney acquires a partnership or joint venture interest in the client's cause of action. Rather, in *Potter*, the Oregon Supreme Court held that the term "lien" in Oregon Revised Statute Section 87.445 is to be given "its ordinary meaning," namely a "charge upon real or personal property for the satisfaction of some debt or duty ordinarily arising by operation of law." 63 P.3d at 1174 (citation omitted). The court went on to hold that the statutory attorney's lien attaches not just to the proceeds of a lawsuit, but to the lawsuit itself. Thus, the attorney in *Potter*, the Court held, could enforce the lien against the defendant, although the defendant had paid the entire amount of the judgment to the plaintiff, who failed to pay the attorney. *Potter* thus stands for no more than the proposition that an attorney in Oregon can recover his fee—hourly or contingent—from a third party who, in contravention of the attorney's lien, pays the entire amount of a judgment or settlement to the attorney's client. That holding preserves an Oregon attorney's rights as a secured *creditor*; it in no way lends support to Banaitis's claim that his attorney was not his creditor, but instead, was his partner or co-venturer.

2. The attorneys were not the "true earners" of the litigation proceeds

Equally without merit is the related theory advanced by respondents and many of the amici that respondents' attorneys were the true "earners" of the contingent-fee portion of the recoveries by virtue of the provision of their legal services, and thus that only the attorneys realized income from those recoveries. See, *e.g.*, Banks Br. 4, 6-7; Banaitis Br. 23-24. Respondents' argument does not withstand analysis.

First, respondents ignore the fact that the legal right to recover damages arises at the time of the actionable *injury*, not when that right is subsequently reduced to judgment with (or without) the assistance of an attorney. Under the law, a plaintiff's right to income is complete when an actionable injury is suffered, because it is the injury that gives rise to the cause of action and provides the measure of the damages recovery to which the plaintiff is entitled. To be sure, an attorney's services may help enforce that income entitlement, but the attorney does not *earn* the damages award; the plaintiff had already "earned" his or her entitlement to that award by suffering injury before the attorney even appeared on the scene. What the attorney "earns" is merely the right to be paid for services rendered.

Second, the factual premise of respondents' argument—that they could not have recovered on their causes of action absent the services of their attorneys—is pure speculation. Many litigants successfully represent themselves, and there is no basis to determine from the record in these cases whether respondents could have achieved the same or similar recoveries had they represented themselves.

Third, and most importantly, even assuming that respondents would not have been able to obtain their recoveries without their attorneys' services, that would not render the contingent-fee portion of their recoveries excludable from their gross income. If respondents had desperately needed attorneys to bring their claims and had employed those attorneys on an hourly-fee basis and then used a portion of their recoveries to pay the fees, it would be undisputed that the *full* amount of the recovery would be taxable income. See *Kenseth* v. *Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001). The extent to which respondents' recoveries were dependent on the skills of their attorneys, therefore, provides no basis for the exclusion from income sought by respondents.

Indeed, there are numerous situations in which portions of a taxpayer's income are attributable to the skilled services of

an agent or assistant employed by the taxpayer. Actors and professional athletes, for example, customarily employ skilled agents to negotiate contracts for them and pay those agents a percentage of the contract amount as a commission. Construction companies employ skilled sub-contractors who are entitled to be paid out of the proceeds of the construction project, a right secured by statutory liens on the project. Many companies use commissioned sales staff to sell their products, and many individuals turn over control of their financial assets to investment advisors whose compensation is a percentage of the value of the assets under their management or the investment income generated. Respondents' theory would mean that such taxpayers may exclude from their gross incomes the payments made to such agents, but there is no authority for that proposition, which would upset long-established principles of federal tax law. The Internal Revenue Code does not mandate more favorable treatment of those who contract for services—whether financial or legal advice—on a commission basis, rather than on an hourly-fee basis.

Thus, for example, a relatively unknown author who employs a leading literary agent for a ten percent commission to secure a publishing contract and who obtains a $1 million book contract largely because of the agent's efforts would realize gross income of $1 million. The $100,000 commission paid to the agent would be an expense of producing that income, just as if they had agreed to a non-contingent flat fee of $100,000 or an hourly rate that produced a $100,000 fee. In each case, that expense, to the extent permitted by the Internal Revenue Code, may be deducted in computing the author's taxable income. But the author could not seriously contend that he realized gross income of only $900,000, because the agent was the "true earner" of the portion of the contract proceeds ($100,000) paid in commission. See *Kenseth*, 259 F.3d at 883 ("If a taxpayer obtains income of $100 at a cost in generating that income of $25, he has gross income of $100 and a deduction of $25, * * * yielding

taxable income of $75 * * *. If, therefore, for some reason the cost of generating the income is not deductible, he has taxable income of $100."). Respondents' attorneys were, in essence, commissioned agents for respondents, and there is no logical reason why their commissions should receive different tax treatment than the commissions paid to other types of agents or more favorable treatment than attorneys paid hourly fees.

3. Respondents had sufficient control over the contingent-fee portion of the proceeds to warrant its inclusion in their gross income

Respondents also err in contending that they did not realize income from the proceeds paid directly to their attorneys because, under their contingent-fee agreements, they never had the right or ability to receive or control that income. As an initial matter, respondent Banks (Br. 11-12) overstates the degree of control necessary to warrant treating the contingent-fee portion of the recoveries as income to respondents. Relying, *inter alia*, on *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1930), and *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203, 209 (1990), he asserts that the contingent-fee portion can only be treated as income to him if at all times he exercised "complete dominion" or "unfettered command" over that portion of his claim. But the cases on which he relies either did not involve a purported transfer or assignment of income at all, or refer to the degree of control necessary *before* the attempted transfer occurs. Respondents plainly exercised "complete" and "unfettered" control over their causes of action prior to the execution of the contingent-fee agreements. Indeed, the very fact that they promised to pay a percentage of any income they might receive as consideration for legal services conclusively demonstrates that they exercised such unfettered control and dominion.

It makes no sense to ask whether respondents continued to exercise complete or unfettered control over the contingent-fee portion of their income *after* they claim to have

transferred control over or otherwise to have assigned that portion to their attorneys. Rather, as explained in petitioner's opening brief (Br. 31-32), this Court's decision in *Commissioner* v. *Sunnen*, 333 U.S. 591 (1948), provides the framework for evaluating such claims. There, the Court stated, "[a]s long as the assignor actually earns the income or is otherwise the source of the right to receive and enjoy the income, he remains taxable," notwithstanding any attempted assignment or transfer. *Id.* at 604. Here, the "source of the right to receive and enjoy the income" was the *injury* suffered by respondents that gave rise to a cause of action under applicable law. Respondents are the sole source of that right, and are therefore taxable on the income it produced.

"The crucial question," the *Sunnen* Court further held, "remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes." 333 U.S. at 604; see *Horst*, 311 U.S. at 117-118 (where the taxpayer has "divert[ed] payment from himself to others as the means of procuring the satisfaction of his wants," he is taxable on the diverted proceeds). Here, respondents plainly retained "sufficient power and control" to warrant including the contingent-fee portion of the recovery in respondents' gross income.

A client who hires an attorney to prosecute a cause of action for him—whether on a contingent or an hourly-fee basis—retains ownership and control over his lawsuit. See *Chauffeurs, Teamsters & Helpers Local No. 391* v. *Terry*, 494 U.S. 558, 568-569 (1990) ("a client controls the significant decisions concerning his representation" and "can fire his attorney if he is dissatisfied with his attorney's performance"). Indeed, regardless of the fee arrangement, all attorneys have an overriding fiduciary duty to act only in the best interests of their clients. Thus, it was respondents, and not their attorneys, who at all times owned and controlled the disposition of their causes of action, and it was therefore

respondents who "earned" the entire amount of the litigation proceeds, including the portion that was paid as fees to their attorneys. As was the case with the father in *Helvering* v. *Horst*, *supra*, who gave up his right to the interest derived from his bond coupons but retained control of the bonds themselves, respondents, by retaining ultimate control of their causes of action, at all times "controlled the source of the income." *Raymond*, 355 F.3d at 116. "[They] could have fired [their] attorney[s]. [They] could have dropped [their] case[s]. [And they], and only [they], had the power to authorize a settlement of [their] claim[s]." *Ibid.*; accord *Kenseth*, 259 F.3d at 884. Because respondents controlled the source of the income, as a matter of federal tax law, the entire amount of litigation proceeds is includable in their gross income.[2]

4. The assignment-of-income doctrine is not limited to so-called "anti-abuse" situations or assignment of already-ascertained income

Banks argues (Br. 23) that the government's case rests not upon any provision of the Internal Revenue Code, but instead "relies exclusively upon a judicially-created anti-abuse rule known as the assignment of income doctrine." That is incorrect. The government's position rests ultimately on 26 U.S.C. 61, which provides that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived." See Pet. Br. 15. It is Section 61 that mandates inclusion of the entire proceeds of respondents' recoveries in their gross incomes. The

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[2] Respondent Banks's claim (Br. 17) that "[b]y entering into the contingent fee contract with his attorney, [he] ceded * * * *all* control over the portion attributable to the contingent fee earned and retained by his attorney" is particularly misplaced. Following the settlement, Banks refused to endorse the settlement check made out to him and his attorney until after his attorney agreed to receive $35,000 less than he was entitled to receive under the contingent-fee agreement. See J.A. 30-31, 36-37. Banks obviously did not relinquish all control over that income when he executed the agreement.

assignment-of-income doctrine, which is based on a long-standing construction of that statutory language, provides a complete answer to respondents' claim that the contingent-fee agreements operated to transfer or assign a portion of the proceeds of their causes of action to their attorneys, thereby diverting the incidence of tax.[3]

Respondents misstate both the intent and scope of the assignment-of-income doctrine. Banks characterizes it (Br. 23-24, 28) as solely an "anti-abuse" rule, and Banaitis similarly argues (Br. 23) that the assignment-of-income doctrine does not apply here because the contingent-fee agreement was "an arms-length transaction between unrelated parties in a commercial setting, for valuable consideration." As our opening brief explained (Br. 33), however, this Court has expressly rejected respondents' assumption that the assignment-of-income doctrine applies only to tax-motivated or bad faith transfers. In *Lucas* v. *Earl*, the Court expressly declined to consider the motives for the assignment of the taxpayer's income, stating that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." 281 U.S. at 115. As the Second Circuit noted in *Raymond*, the *Earl* Court recognized that resting application of the assignment-of-income doctrine on the motives of the parties would be "to court procedural unmanageability" by placing the courts "in the position of having to divine the unknowable." 355 F.3d at 117. The fundamental rule of *Earl* is that income is to be taxed to the

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[3] Nor is it true that the government's interpretation of Section 61 rests exclusively on the assignment-of-income doctrine. As demonstrated in Part B, *infra*, and in our opening brief (Br. 19, 30), the contingent-fee agreements at issue here gave rise to contingent debts running from respondents to their attorneys, and under the principle established in *Old Colony Trust*, *supra*, the direct payment by third parties to respondents' attorneys of the debts owed by respondents was income to respondents in the amount of the discharged debts, without regard to the applicability of the assignment-of-income doctrine.

person who earns it even where it is diverted in such a manner that it never vests in the taxpayer. It is of no moment why a taxpayer made an anticipatory assignment of his prospective income.[4]

Banaitis seeks to deflect the assignment-of-income doctrine by contending (Br. 24) that the income in *Earl* and *Horst* "had already been earned" or "was virtually certain to be earned." He urges that the assignment-of-income doctrine does not apply where the recovery is "an intangible, contingent expectancy." *Ibid.* (citation omitted). But the assignment-of-income doctrine is not so limited. Rather, as the Second Circuit pointed out in *Raymond*:

> [In *Earl*], the husband and wife agreed to co-own any future income each might earn. There existed no sum certain at the time of the agreement, and yet once the husband earned income and claimed that a portion of it had shifted to his wife, the Court found it to be an improper assignment of income. In both this case and *Earl*, the taxpayers assigned the right to receive a portion of as yet unascertained income to another.

355 F.3d at 116-117. The assignment-of-income doctrine thus does not rest on the certainty of the income assigned.

Banks (Br. 30-31) and Banaitis (Br. 25) argue that a private ruling issued by the IRS, P.L.R. 200427009 (Mar. 19, 2004), confirms that "motivation is a significant factor" in applying the assignment-of-income doctrine and that the doctrine generally does not apply to a transfer of a claim in litigation because "such claims are contingent and doubtful in nature." Private rulings are unofficial administrative interpretations issued by branch offices that "may not be used or cited as precedent," 26 U.S.C. 6110(k)(3), and are not representative of the published position of the IRS. In any

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[4] Ironically, respondents' proposed construction of the statute would entail significant and unjustified tax advantages for contingent-fee arrangements over hourly- or flat-fee arrangements and would thereby create incentives for tax-motivated arrangements like those respondents contend gave rise to the assignment-of-income doctrine.

event, that ruling did not involve a purported assignment under a contingent-fee agreement and does not support respondents' arguments that lack of a tax-avoidance motive or uncertainty as to the amount of future income precludes application of the assignment-of-income doctrine. The IRS's official position that the portion of litigation proceeds used to pay attorney's fees is includable in the litigant's gross income is embodied in a Revenue Ruling, which (unlike the private letters cited by respondents) does represent the published position of the IRS on this question. See Rev. Rul. 80-364, 1980-2 C.B. 294, Situation 1 (where employee's damages award includes attorney's fee component, "the full amount of the award is income to the employee and must be included in the employee's gross income").

5. There is no proscription in the tax law against the purported "double taxation" at issue here

Banks (Br. 35-38) and Banaitis (Br. 30) both argue that the contingent-fee portion of their recoveries cannot be included in their gross income because that would result in "double taxation," *i.e.*, the same income would be taxed to two separate individuals. As petitioner's opening brief explains (Br. 34-35), there is no "double taxation" involved in these cases. The fact that the full award is taxable to the client and the fees are income to the attorney is neither anomalous nor harsh, but is instead a commonplace feature of the Internal Revenue Code. If, for example, a taxpayer hires an investment advisor and agrees to pay him a fee equal to a percentage of the investment income generated by the advisor, the full investment income is taxable to the investor and the percentage-based fee is taxable to the advisor. Moreover, the fees paid to the advisor would be a miscellaneous itemized deduction under 26 U.S.C. 67(b) and 212(1) and, as such, would not be allowable for purposes of the Alternative Minimum Tax (AMT). See 26 U.S.C. 56(b)(1)(A)(i). More broadly, whenever a taxpayer uses taxable income to purchase goods or services for which

Congress has either not allowed or limited a deduction, the original income will be taxed to the purchaser, and the seller will pay taxes on his income from the sale. But there is no "double taxation" in any meaningful sense.

Respondents' reliance on authorities holding that double taxation requires a clear expression of congressional intent is therefore misplaced. Those authorities concern true double taxation, *i.e.*, the taxation of the *same* income twice —not the taxation of two income events recognized by *different* taxpayers, although involving the same funds. See, *e.g.*, Banks Br. 35-38; Banaitis Br. 30. In any event, even if a clear expression of congressional intent were required here, it would be provided by the AMT's clear prohibition of any deduction for miscellaneous itemized deductions. See 26 U.S.C. 56(b)(1)(A)(i).

B. The Contingent-Fee Portion Of The Proceeds Is Includable In Respondents' Gross Income Because It Satisfied Respondents' Debts To Their Attorneys

This Court established in *Old Colony Trust*, 279 U.S. at 729, the fundamental federal tax principle that when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives "income" in the amount of the discharged debt. That principle independently compels reversal here. The fee agreements executed by respondents gave rise to a contingent debt owed by them to their attorneys, which became a fixed debt when respondents recovered on their causes of action.

Respondents (Banks Br. 34-35; Banaitis Br. 16-17) and some of their amici assert, however, that there was no debtor-creditor relationship between respondents and their attorneys. They rely on the fact that respondents' attorneys would not have been entitled to any payment if respondents had not recovered on their causes of action, and they assert that respondents had no personal liability for the amounts due their attorneys under the fee agreements. Those arguments are meritless. The critical question is the relationship

between respondents and their attorneys at the time the payments to the attorneys were made. At that time, respondents' contingent obligations had become fixed. That, after all, is the reason the payments were made: Respondents were required by the terms of their fee agreements to pay specified portions of their recoveries to their attorneys. If respondents had received and retained all of the proceeds without paying the fees owed their attorneys, respondents would have been personally liable in the amount of the unpaid fees. Thus, the direct payment to respondents' attorneys by third parties discharged respondents' debts to their attorneys, and respondents thereby realized income in the amount of the discharged debts. See *Old Colony Trust*, 279 U.S. at 729; *Hukkanen-Campbell*, 274 F.3d at 1313-1314; *Baylin*, 43 F.3d at 1454.

That the relationship between respondents and their attorneys was that of debtor-creditor is confirmed by the lien granted under state law to respondents' attorneys. A lien is defined as "[a] legal right or interest that a *creditor* has *in another's property*, lasting usu[ally] until a debt or duty that it secures is satisfied." *Black's Law Dictionary* 933 (7th ed. 1999) (emphases added). A lien thus is an interest in a debtor's property that is granted to his creditor as security for payment of the debt. See *Kenseth*, 259 F.3d at 883. If, as respondents and most of their amici assert, the contingent-fee agreements entered into by respondents gave rise to no indebtedness running between respondents and their attorneys, there would be no basis for the liens granted to the attorneys under state law.

It is undisputed that an amount owed by a client to his attorney under an hourly-fee arrangement is a debt running from the client to his attorney. Since the attorney lien statutes in both California and Oregon, as well as those in other States, provide precisely the same lien to attorneys paid under an hourly-fee arrangement and attorneys paid under a contingent-fee arrangement, there is no logical basis for respondents' conclusion that while hourly fees owed by a

client to his attorney constitute a debt of the client, fees owed by a client to his attorney under a contingent-fee agreement do not.

C. Any Inequity That May Result From The Application Of The AMT To Contingent Attorney's Fees Is Within The Sole Power Of Congress To Remedy

Banks argues (Br. 21) that the inclusion in gross income of the attorney's fee portion of a recovery leads to "harsh and absurd results," in that taxes and attorney's fees could conceivably consume all of a client's recovery. This argument is misconceived, because any such "harshness" is a product of application of the AMT in this context, which is mandated by the plain language of the statute. Respondents' legal expenses are deductible under 26 U.S.C. 212(1), as "ordinary and necessary expenses paid or incurred * * * for the production or collection of income." Expenses deductible under Section 212(1) are itemized deductions, see 26 U.S.C. 211, and are classified as "miscellaneous itemized deductions" by 26 U.S.C. 67(b). Section 56(b)(1)(A) expressly provides that, in computing the AMT, "[n]o deduction shall be allowed * * * for any miscellaneous itemized deduction." There is no valid basis for disregarding the plain language of these directly applicable statutory provisions. If the application of the AMT has the potential to lead to harsh results in some cases, it is a matter that only Congress has the power to remedy. See *Commissioner* v. *Asphalt Prods. Co.*, 482 U.S. 117, 121 (1987) ("[j]udicial perception that a particular result would be unreasonable may enter into the construction of ambiguous provisions, but cannot justify disregard of what Congress has plainly and intentionally provided"); *Alexander* v. *IRS*, 72 F.3d 938, 946-947 (1st Cir. 1995) (recognizing that, although application of AMT to legal fees may result in a seemingly unfair outcome, "there is [no] inequality of treatment as compared to similarly situated taxpayers [and] * * * [i]t is well established that equitable

arguments cannot overcome the plain meaning of the statute").

Congress, moreover, is aware of concerns over the potential application of the AMT to litigation proceeds. It is currently considering proposed legislation that would provide an above-the-line deduction under 26 U.S.C. 62 (2000 & Supp. I 2001)—*i.e.*, a deduction that would be allowed in computing the AMT—for "attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination." Jumpstart Our Business Strength (JOBS) Act, H.R. 4520, 108th Cong., 2d Sess. § 643 (2004). That proposed legislation has been passed by the Senate and referred to the conference committee. See *Bill Summary and Status for the 108th Congress* <http://thomas.loc.gov/cgi-bin/bdquery/z?d108: HR04520:@@@X>. This proposed legislation reflects the ability of Congress to address any perceived unfairness in particular types of litigation. Respondents, by contrast, ask the courts to alter the tax treatment of *all* contingent-fee awards without any basis in statutory text.

In addition, Banks states (Br. 18) that the statutory causes of action on which his lawsuit was based contained "fee-shifting" provisions, under which the court allegedly could have awarded attorney's fees separate from and in addition to damages compensating the plaintiff for injuries and losses suffered. Banaitis contends (Br. 42, 45) that the government is "apparently attempting" to tax attorney's fees paid under fee-shifting statutes. The fees here, however, were paid under contingent-fee agreements, not under fee-shifting statutes. There was no award of statutory attorney's fees, and the attorney's fees paid to respondents' counsel were a percentage of the settlement proceeds, as provided in the fee agreements, not a "reasonable" fee calculated under the "lodestar" approach applicable under fee-shifting statutes. See, *e.g.*, *Hensley* v. *Eckerhart*, 461 U.S. 424, 433 (1983). The question whether attorney's fees awarded under fee-shifting statutes are excludable from the

plaintiff's gross income is therefore not presented here, and the Court need not decide that issue to resolve these cases. Moreover, the legislation currently pending before Congress is narrowly focused on certain civil rights cases, which are also the cases in which most fee-shifting occurs, and so, if enacted, would largely resolve that issue, while leaving intact the general principle that all litigation proceeds, including those paid to an attorney, are includable in the litigant's gross income.

In any event, respondents' concerns are exaggerated, because they ignore important distinctions between statutory fee awards and contingent fees. To be sure, in the absence of an assignment, it is the prevailing plaintiff, and not the attorney, that owns the claim for fees under a fee-shifting statute. See, *e.g.*, *Evans* v. *Jeff D.*, 475 U.S. 717, 730-732 (1986). That the prevailing plaintiff owns and controls the claim for fees would support treating an award of attorney's fees under a fee-shifting statute as gross income to the plaintiff in some instances—for example, where the plaintiff retains all or part of the award and is not contractually obligated to transfer the award to his attorney, see *Blanchard* v. *Bergeron*, 489 U.S. 87, 95 (1989), or where the fees are paid directly to the attorney in satisfaction of a debt owed by the prevailing party, see *Sinyard* v. *Commissioner*, 268 F.3d 756, 759-760 (9th Cir. 2001), cert. denied, 536 U.S. 904 (2002). This Court indicated in *Jeff D.*, however, that a prevailing plaintiff may be free to assign his statutory claim for attorney's fees to his attorney, see 475 U.S. at 730-731 (noting Congress "did not prevent the party from waiving this eligibility [for attorney's fees] anymore than it legislated against assignment of this right to an attorney"), and such assignments are not uncommon. Once such an assignment has occurred, courts generally permit the lawyer to sue on his own behalf to recover his fees, without the participation or consent of the prevailing party, see, *e.g.*, *Carpa, Inc.* v. *Ward Foods, Inc.*, 536 F.2d 39, 52 (5th Cir. 1976); *Goodman* v. *Heublein, Inc.*, 682 F.2d 44, 47-48 (2d Cir. 1982). If such an

assignment is viewed as a transfer of the entirety of the attorney's fee claim to the lawyer, such that the prevailing party retains no meaningful interest in or control over the claim, then it may be possible to view any recovery on that claim as income only to the lawyer.

* * * * *

For the foregoing reasons, and for the reasons stated in our opening brief, the judgments of the courts of appeals should be reversed with respect to the issue of the tax treatment of contingent attorney's fees.

Respectfully submitted.

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